

When will the global economy return to rapid growth?

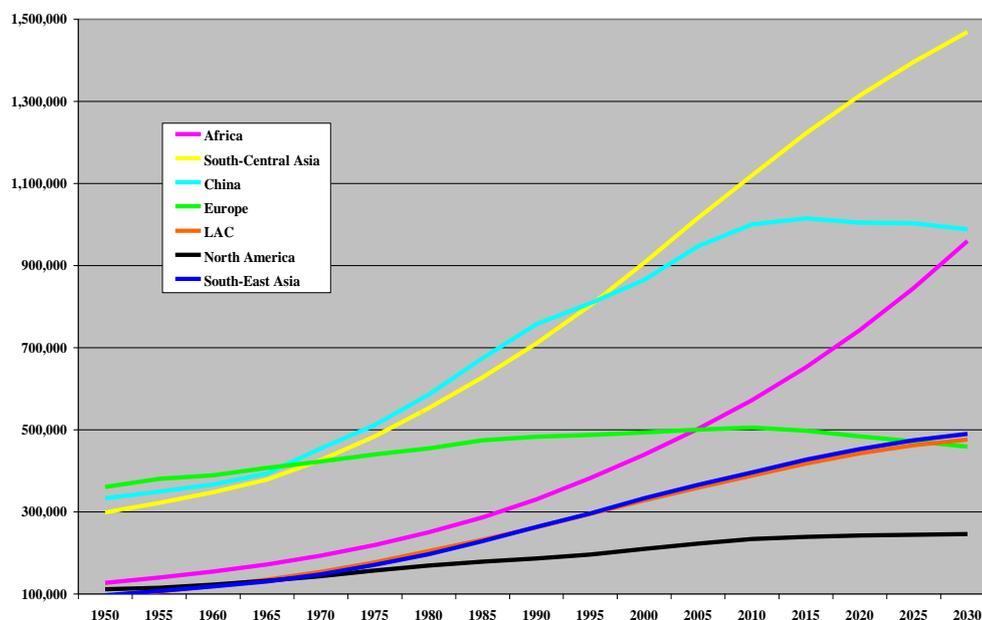
Marek Dabrowski

Short-term vs. long-term growth factors

More than six years have passed since the subprime mortgage crisis began in the US in the summer of 2007. In the following year, it spread to the entire world economy. Its consequences have not been fully overcome yet. Thus it's not surprising that economists' attention has been largely devoted to short-term, crisis-related issues like financial deleveraging and repairing the balance sheets of governments, corporations and households. For the macroeconomic policy debate, this means concentrating on demand management by using monetary and fiscal policy tools in order to return to a pre-crisis growth path. Rarely has the question been asked of whether or not this is a realistic goal, i.e., whether post-crisis growth can return to pre-crisis levels.

An analysis of growth perspectives in the medium-to-long-term calls for using the neo-classical growth theory, according to which there are three factors at play: labor, capital and total factor productivity (TFP). In this brief we will try to figure out what their expected dynamics are and how much each of them can contribute to economic growth in the foreseeable future.

Figure 1: Working age (15-64) population by regions, in thousands, 1950-2030

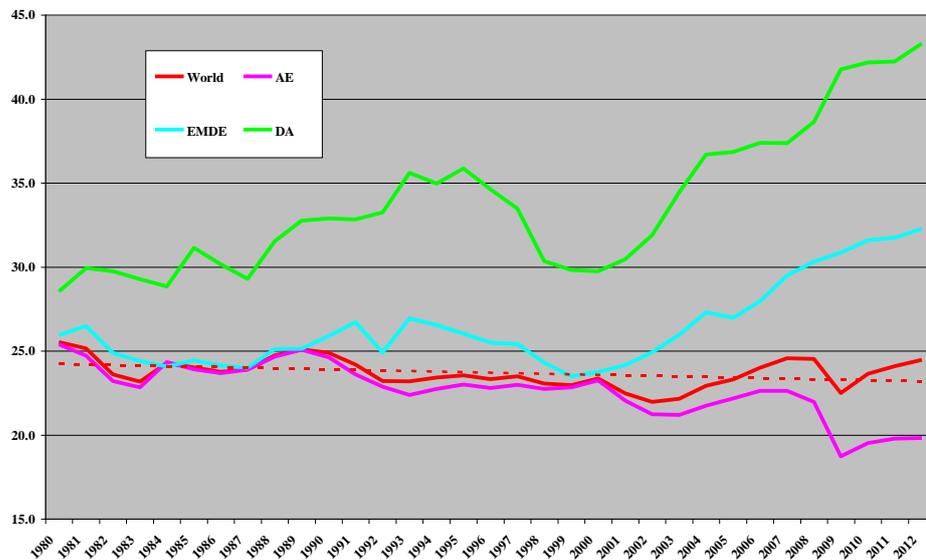


Note: for 2015-2030 Medium Variant Projection; LAC – Latin America and Caribbean
 Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2012 Revision, <http://esa.un.org/unpd/wpp/index.htm>

Demographic crisis

The working age population (15-64) of most European countries and Japan is declining, as demonstrated in Figure 1. China and several other Asian countries (Singapore, South Korea and Thailand) will soon follow the same trend. In North America, potential labor resources will continue to grow over the next 15 years, though at a very slow pace. In Latin America and the Caribbean, this growth will be faster (as compared to North America), but will occur at a steadily declining rate.

Figure 2: Investment as % of GDP, country groups, 1980-2012



Source: IMF World Economic Outlook database, October 2013

Some countries, such as Chile, will experience the beginning of negative growth.

The working age population will continue to grow at a rapid pace in Africa, the Middle East and South Asia. However, the labor absorption capacities of those regions will remain limited due to the shortage of capital and numerous institutional obstacles, including labor market rigidities, limited social mobility, and insufficient skills.

More migration from labor surplus to labor deficit regions might at least provide a partial solution. However, cultural, social and political resistance to large-scale migration in labor-importing countries, especially in Europe and East Asia (less so in the US, Canada and Australia), limits the extent to which the domestic shortage of labor can be replaced by imported labor. For example, in order to stabilize the size of its working-age population at the 2010 level (505 million), European countries would need to attract more than 50 million additional migrants from other continents (plus their

families) through 2030, which is politically and socially problematic.

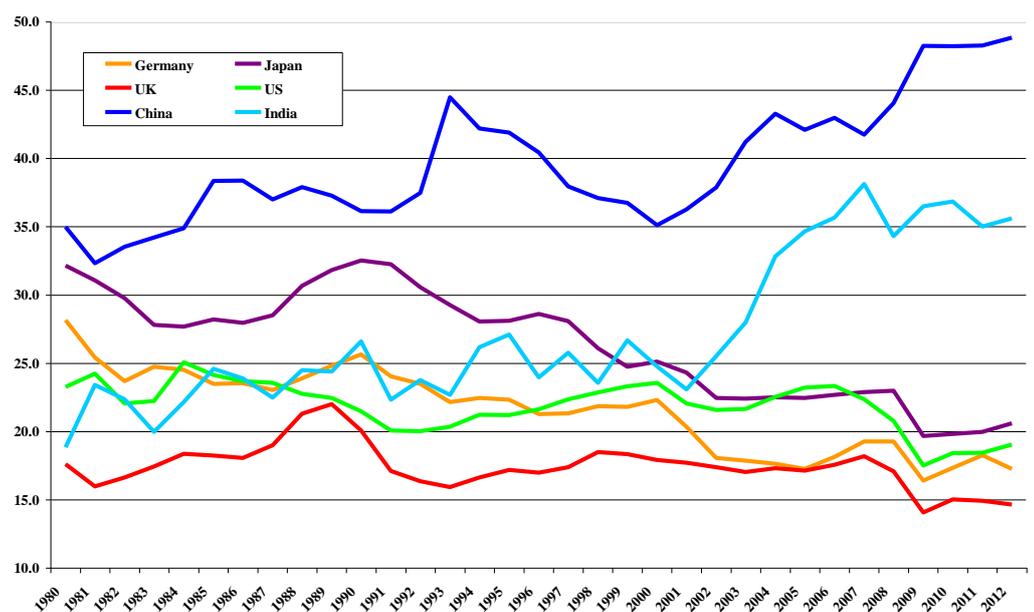
Another remedy for the decreasing working-age population is to increase the labor market participation rate, especially among females and the elderly. This, in turn, should be connected with an increase of both the official and actual retirement age. Again it would not be able to fully compensate for the labor shortage originating from a population decline.

Declining investment rate

The world economy cannot count on more investment. The global investment-to-GDP ratio has been slowly declining over the last 30 years, as demonstrated by the red dotted line in Figure 2. And there is no reason to expect it will increase in the medium-to-long-term.

The investment rate in advanced economies (AE), including all G7 countries, has been systematically declining over the last 30 years (see Figures 2 and 3). Its decrease has been compensated by a rapid increase in the investment rate in emerging market and developing economies (EMDE).

Figure 3: Investment as % of GDP, largest economies, 1980-2012



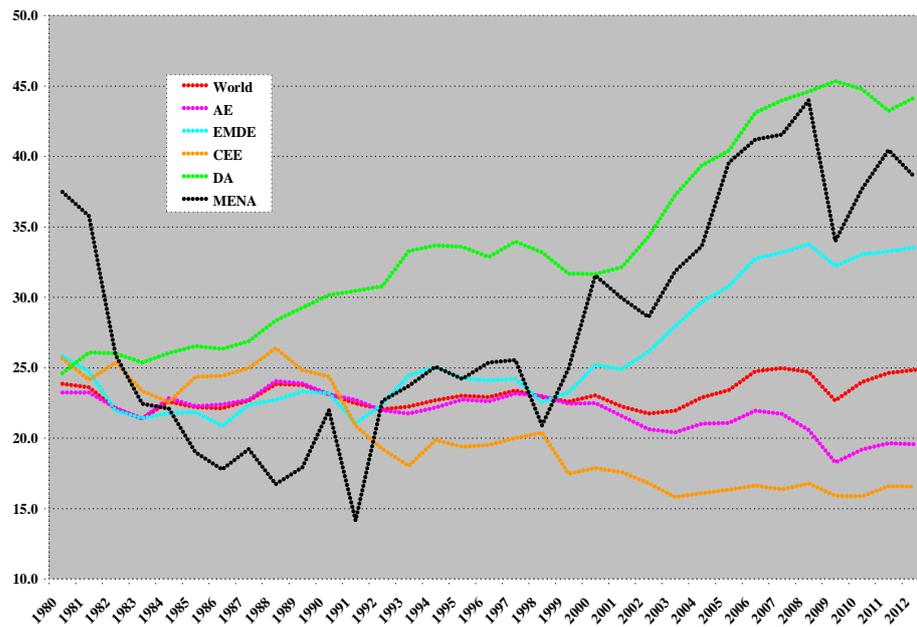
Source: IMF World Economic Outlook database, October 2013

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However, most of this trend can be accounted for by just one region, i.e. Developing Asia (DA), including the two largest emerging-market economies, China and India. Clearly, their extraordinarily high investment rates cannot be sustained forever (especially in China, where it has approached 50% of GDP since 2009). As demonstrated by the experience of Japan, the rates will have to decline once China approaches higher income-per-capita level.

Figure 4: Gross national savings as % of GDP, country groups, 1980-2012



Source: IMF World Economic Outlook database, October 2013

The global investment rate may also be constrained by limited global savings. Over the last 15 years, the major contribution to the global savings pool came from EMDE (see Figure 4) and, more specifically, from its two regions – DA and MENA (Middle East and North Africa). In the second case, this has been clearly determined by the high hydrocarbon prices. As in the case of investments, there is a question of the sustainability of the extremely high savings rate in China (more than half of GDP since 2006), especially in the context of expected rapid population aging and building the public social safety net.

As shown in Figure 4, gross national savings in relation to GDP in AE and some emerging market regions such as Central and Eastern Europe (CEE) have systematically decreased since the 1980s. This trend is unlikely to be reversed any time soon due to population ageing, high public sector borrowing requirements, and historically low interest rates.

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Uncertain prospects of innovation and policy reforms

In the second half of the 1990s and the early and mid-2000s, the world economy benefited from innovations in information and communication technologies (ICT), the peace dividend after the end of the Cold War and fundamental reforms in several former communist economies and developing countries. In particular, one can mention global trade liberalization (the successful completion of the Uruguay round in 1994), the far-reaching liberalization of capital movement, and market-oriented reforms in many regions, including China, India, and other Asian economies, Latin America, CEE and the former Soviet Union, and less so in MENA. As a result, the increase in TFP was a powerful engine of global growth in the decade preceding the recent global financial crisis.

Currently it is difficult to note any new major qualitative growth impulses both on the innovation and policy reform fronts. The pro-growth effects of the ICT revolution, sometimes called the Third Industrial Revolution, seem to be over, earlier than one might have expected a decade ago¹. No new fundamental innovation which can push up TFP can be identified in the near-to-medium-term horizon.

The new round of global trade negotiations that started in November 2001 (the so-called Doha Development Round) was stalled in 2008 with no prospects of a revival in the near future. Although the alternative route, i.e. the proliferation of bilateral and regional free trade agreements, would be beneficial to their parties, it does not necessarily contribute to liberalizing global trade and improving the global allocation of factors of production, especially in such politically sensitive areas as agriculture and services. On the other hand, the prolonged period of financial crisis, slow growth, and high unemployment, creates the temptation to resort to various kinds of protectionist measures.

¹ See Robert J. Gordon "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds", NBER Working Paper, No. 18315, August 2012, <http://www.nber.org/papers/w18315>

Financial liberalization was largely completed in the 1990s and early 2000s (apart from China and India and a few other developing countries) and the challenge now is to resist the temptation of its reversal, similarly to trade in goods and services.

The era of great systemic reforms, such as the transition from centrally planned economies to market systems in former Soviet bloc countries, China, and Vietnam or moving away from macroeconomic populism and import-substitution development strategies in Latin America, also seems to be over. Although there is still a large pending policy reform agenda both in AE and EMDE (see below), they require time and effort to be completed and deliver visible benefits. The low-hanging fruits are largely gone.

Conclusions and solutions

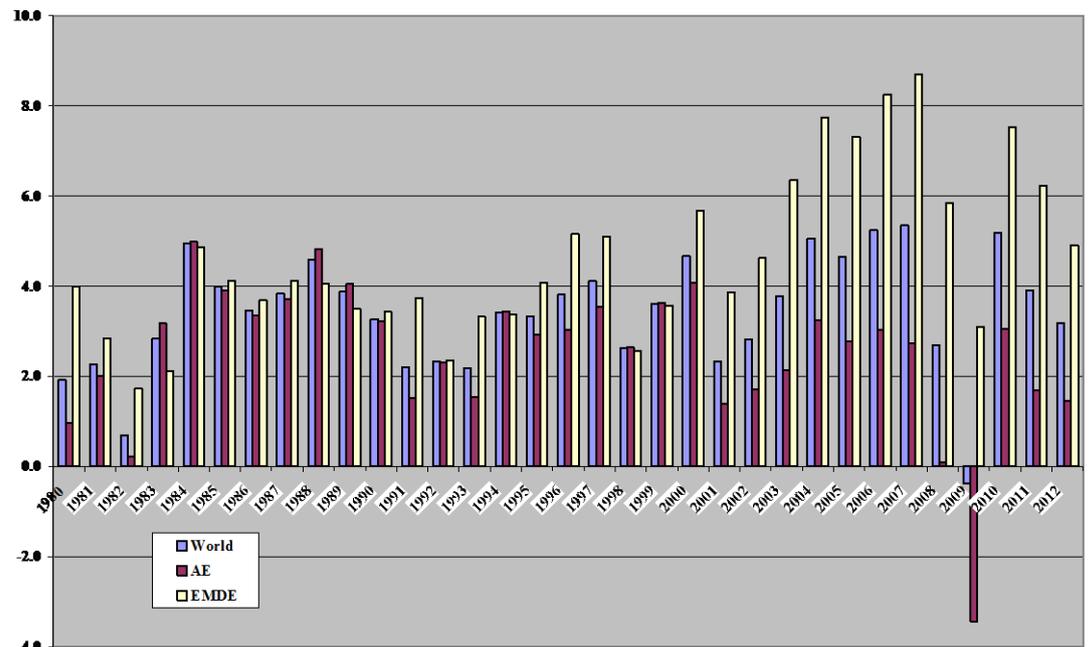
The purpose of this commentary is not to create a feeling of fatality and hopelessness. On the contrary, the aim is to provide a strong message in favor of intensifying the policy reforms at the global and national levels that were stalled by the perception of relative prosperity in the mid-2000s and the accompanying political opportunism, and to call for realism in macroeconomic projections.

Let us start with the second issue. Our analysis of supply-side growth factors leads us to the conclusion that the world economy will not return to the high growth rates which it enjoyed from 2003 to 2007 anytime soon (see Figure 5). In other words, potential growth in the next several years will be lower than it was before the recent global financial crisis and which many policymakers would like to see continue.

More realistic assumptions of potential growth should lead to a reassessment of the role of both monetary and fiscal policies in short-term demand management. If actual growth is not that much lower than potential growth (if it is at all), continuing extremely lax monetary policies may lead to very unpleasant consequences such as the creation of new bubbles or inflation pressures.

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Figure 5: GDP in constant prices, annual change in %, country groups, 1980-2012



Source: IMF World Economic Outlook database, October 2013

The continuation of fiscal stimuli will only make the sovereign debt crisis more severe and will harm the prospects of economic growth in the medium to long term by decreasing the pool of global savings available to finance private investment.

Instead of monetary and fiscal policy fine-tuning, policymakers' efforts should focus on removing structural and institutional bottlenecks to economic growth in the medium and long-term perspectives. In the case of AE, these are the consequences of negative population growth and its aging, labor market rigidities, the excessive burden of the welfare state, and the resulting, high, distortive taxes and sovereign over-indebtedness. In EMDE, the main challenge is related to poor business climate, which has its roots in governance failures and associated phenomena such as pervasive corruption, state capture, deficit of rule of law and organized crime. Poor technical infrastructure, insufficient human capital, financial underdevelopment and excessive public ownership are also relatively common obstacles to rapid economic growth. In addition, some EMDE suffer from trade protectionism, restrictions to foreign capital, macroeconomic populism, and excessive and poorly targeted welfare programs.

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At the global level, it is important not only to complete the Doha Round but also to resist protectionist pressures in the trade, financial and the migration policies of individual countries. The free flow of goods, services, capital and, to the extent possible, labor, is vitally important for the enhancement of TFP and the elimination of regional mismatches between the supply of labor resources and savings and the demand for them.

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Marek Dabrowski is a CASE Fellow. Since the late 1980s, he has been involved in policy advising and policy research in Central and Eastern Europe, Central Asia, Africa, and the Middle East. He has also worked on international research projects related to monetary and fiscal policies, currency crises, international financial architecture, EU and EMU enlargement, European integration, European Neighborhood Policy and the political economy of transition.